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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1941

No. 128

No. 129

BONDHOLDERS COMMITTEE, MARLBOROUGH INVESTMENT COMPANY, FIRST MORTGAGE BONDS, *Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

MARLBOROUGH HOUSE, INC., a corporation, *Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

AND BRIEF IN SUPPORT THEREOF

STEPHEN V. CAREY,
W. Z. KERR,
R. B. ALBERTSON,
Attorneys for Petitioner,
1309 Hoge Building,
Seattle, Washington.

KERR, McCORD & CAREY,
of Counsel,
Seattle, Washington

FRAYN PRINTING COMPANY

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of Counsel,
Seattle, Washington

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COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR WRITS OF CERTIORARI

To the Honorable, the Chief Justice and the Associate Justices of the Supreme Court of the United States:

The joint petition of BONDHOLDERS COMMITTEE, MARLBOROUGH INVESTMENT COMPANY, FIRST MORTGAGE BONDS, AND MARLBOROUGH HOUSE, INC., a corporation, respectfully sets forth the following:

SUMMARY STATEMENT OF MATTER INVOLVED

These causes involve deficiency income tax liabilities. The Commissioner determined a deficiency against the petitioner, the Bondholders Committee, Marlborough Investment Company, First Mortgage Bonds, in the sum of $1,498.02 representing tax on income received by the Committee during the period prior to the organization of the Marlborough House, Inc., from July 1 to November 20, 1933, inclusive, plus a penalty of 25% for failure of the committee to file a return on such income on the theory that the Committee's powers were so broad as to render it a corporation under Article 1314, Regulation 77, Revenue Act of 1932 (R. 13).

The Commissioner also determined a deficiency against Marlborough House, Inc., for the period from November 20, 1933, to December 31, 1933, of $245.33 and for the years 1934 of $441.76 and 1935 of $1,120.35 (R. 234-235).

The taxpayers secured a reversal of the ruling of the Commissioner in the Board of Tax Appeals (In re *Marlborough House, Inc.*, 40 B.T.A. 822, R. 23-43). The Commissioner petitioned the Circuit Court of Appeals for the Ninth Circuit for review and the causes were consolidated for hearing in the Circuit Court (R. 64). The Circuit Court decided the cause in favor of the Commissioner on March

8, 1941 (R. 261). A petition for rehearing was denied on April 17, 1941 (R. 284).

All of the deficiencies are the outgrowth of the Commissioner's determination that the basis for depreciation is the price paid for mortgaged property by the Bondholders Committee at a foreclosure sale of a first mortgage bond issue by the Marlborough Investment Company, an insolvent corporate mortgagor (R. 8, 14, 15, 209, 211, 212).

The taxpayers both claimed a greater basis of valuation for calculating depreciation, namely, costs of the insolvent mortgagor, the Marlborough Investment Company, a corporation, 97% of whose first mortgage bonds the Bondholders Committee held at the time it acquired possession and title to the property (R. 214), because the steps and proceedings by which the taxpayers acquired title to the property bring the taxpayers within the reorganization provisions of the applicable revenue acts, and, if so, the depreciation allowances claimed by the taxpayers are sufficient deductions from gross income to avoid deficiency liability. The taxpayer also claims that even if there was no reorganization within the contemplation of the statutes, the depreciation allowance to the taxpayers should be based on the sum of $466,968, the par value and cost of bonds held by the Committee and paid in as a part of the purchase price in the foreclosure sale, plus other cash advances by bondholders to secure

possession and title, and not the price bid at the foreclosure sale, $340,425.

On May 20, 1927, the Marlborough Investment Company, a corporation, issued its bonds in the sum of $500,000.00, secured by a mortgage deed of trust on an apartment building and furniture, known as the Marlborough House. The mortgagor defaulted in the payment of the bonds on May 10, 1932, at which time the amount of outstanding bonds was $453,900.00 (R. 26).

Shortly after default, a Bondholders Committee was organized and a written deposit agreement was executed, giving the Committee broad powers, including the power to acquire the property at foreclosure sale, or otherwise, and the power to organize a new corporation and convey the property to such corporation in exchange for such corporation stock, and to distribute the stock so received to depositing bondholders (R. 26, 27).

Holders of $441,100.00 of par value bonds, approximately 97% of the amount outstanding, deposited under the agreement. Holders of but $12,800.00 par value bonds failed to deposit. Pursuant to instructions from the Bondholders Committee, the trustee of the mortgage deed of trust instituted foreclosure proceedings (R. 31).

While the foreclosure was pending, at the request

of the Bondholders Committee, the plaintiff trustee, on July 1, 1933, entered into a written stipulation with certain defendants who were in possession of the mortgaged property, holding title by mesne convenances from the mortgagor, by the terms of which these defendants agreed to execute and deliver quit claim deeds for all of the mortgaged property in consideration of $10,025.00 cash, paid by the Committee (R. 31). These deeds were delivered on that day. The deeds left the grantee's name blank, but the stipulation specifically authorized the plaintiff, or its attorneys to insert the name of the grantee in the deed, which was done in 1938 (R. 32, 79-81).

Part of the stipulation of July 1, 1933, required possession of the mortgaged property to be immediately yielded to the plaintiff or its nominee. The Bondholders Committee appointed Russell C. Perkins as its agent with authority to collect rents, pay expenses of management, and take possession of the property. Perkins, on July 1, 1933, went into physical possession of the property, and performed these duties from July 1 to November 20, 1933. As a part of this transaction, on July 1, 1933, through its attorney, the Marlborough Investment Company, the insolvent mortgagor, approved the form of the foreclosure decree which was entered on the same day (R. 33, 154).

A foreclosure sale was held September 30, 1933.

The Bondholders Committee bid in the property at the foreclosure sale for $340,425 (R. 33). The price was paid by a deposit with the sheriff of $441,100 par value in bonds, $6425.64 cash, to cover the costs and expenses of the proceedings, and $9418.24 cash, to pay non-depositing bondholders their pro rata portion of the purchase price (R. 164).

The Committee determined the amount of its bid at the sale to some extent by the amount of the cash available for payment to non-depositing bondholders, and to some extent by its desire to assure depositing bondholders of an adequate and fair return on the investment in the event of a redemption of the property (R. 34, 72). The sale was confirmed October 16, 1933 (R. 164).

The Bondholders Committee, on November 10, 1933, organized the Marlborough House, Inc., a corporation, and on November 20, 1933, transferred possession of the mortgaged property, and assigned the sheriff's certificate of purchase to the new corporation in exchange for all of its capital stock (R. 11, 12). This capital stock was distributed pro rata to the depositing bondholders. The common stockholders of the Marlborough Investment Company, because of the insolvency, received nothing.

Because of the severe financial depression subsequent to July 1, 1933, the Bondholders Committee made no attempt to sell the property, nor was there a market for its sale between July 1 and November

20, 1933. Neither the fair market value of the bonds deposited with the Committee, plus the cash required to purchase the property, nor the fair market value of the property was in excess of $340,425 at the date of the foreclosure sale, or on July 1, 1933 (R. 34).

The taxpayers assert that there was a reorganization within the intent of the applicable sections of the Revenue Act of 1932, although the stockholders of the insolvent mortgagor corporation are given no participation in the new corporation. When encumbered assets of the corporation are substantially less than its bonded debt, the bondholders are, for all practical purposes, the corporation. When under such circumstances bondholders become the moving spirit in a reorganization of the properties and act as owners-in-fact of the old corporation's assets in carrying out their plan, even through the medium of a foreclosure sale, there is accomplished a reorganization of a practical and common sense type within the intent of Section 112 (a) (3) and Section 112 (i) (l) (a) of the Act of 1932. The depreciation basis for the Committee and new corporation should be the same as in the hands of the predecessor, the insolvent corporation, less depreciation already taken by such predecessor, Section 113 (a), Section 113 (a) (6) and (a) (7), Section 114 Act of 1932.

The Commissioner and the taxpayers are in

agreement that the basis for depreciation of the property in the hands of the Marlborough House, Inc., is the same as in the hands of the committee, Section 113 (a) (8) and Section 112 (b) (5) with adjustments as provided in Section 113 (b).

JURISDICTION

1. The jurisdiction of this court is invoked under Section 240 (a) of the Judicial Code as amended by Act of February 13, 1935, 43 Stat. 938, 28 U. S. C. A. Section 347 (a).

2. The date of the judgment of the Circuit Court of Appeals of the Ninth Circuit herein sought to be reviewed is March 8, 1941, and petition for rehearing was denied April 17, 1941.

QUESTIONS PRESENTED

1. Did not the Circuit Court of Appeals of the Ninth Circuit err in refusing to hold that the steps taken by the Bondholders Committee, Marlborough Investment Company, and Marlborough House, Inc., constituted a reorganization whereby the Committee and the Marlborough House, Inc., as parties to the reorganization were entitled to the same basis for depreciation as the predecessor insolvent mortgagor corporation, the Marlborough Investment Company?

2. Did not the Circuit Court of Appeals of the Ninth Circuit err in refusing to hold that this case was controlled by rules laid down in *Commissioner vs. Newberry L. & C. Co.*, 94 Fed. (2d) 447 (C. C. A.

6th) and *Commissioner vs. Kitselman,* 89 Fed. (2d) 458 (C. C. A. 7th)?

3. Did not the Circuit Court of Appeals for the Ninth Circuit err in interpreting the holdings of *LeTulle vs. Scofield,* 308 U. S. 415, and *Helvering vs. Tyng,* 308 U. S. 527, as overruling the cases of *Commissioner vs. Kitselman* supra and *Commissioner vs. Newberry L. & C. Co.* supra?

4. Did not the Circuit Court of Appeals of the Ninth Circuit err in holding that there was a lack of continuity of interest between the Marlborough Investment Company, the Committee, and the Marlborough House, Inc., because the stockholders of the predecessor Marlborough Investment Company did not participate in the stock of Marlborough House, Inc.?

5. Did not the Circuit Court of Appeals of the Ninth Circuit err in failing to hold that Section 113 (a). (7) was applicable to the facts found by the Board of Tax Appeals, even if Section 113 (a) (6) cited in the Board's opinion was inapplicable?

6. Did not the Circuit Court of Appeals of the Ninth Circuit err, after holding there was a break in the continuity of proprietory interest, in refusing to consider the cash advanced by the Committee plus the par value and cost of the bonds, a total of $466,968, as the basis of the cost of property under Section 113 (a) of the 1932 Act, rather than the amount bid at the foreclosure sale, $340,425?

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRITS

1. The decision of the Circuit Court of Appeals for the Ninth Circuit is in conflict with the decision of *Newberry L. & C. Company,* 94 Fed. (2d) 447 (C. C. A. 6th) and *Commissioner vs. Kitselman,* 89 Fed. (2d) 458 (C. C. A. 7th). Since the decision by the Circuit Court of Appeals of the Ninth Circuit, two decisions have been rendered by the Circuit Court of Appeals of the Fifth Circuit on substantially the same matters, contrary to the decision of the Ninth Circuit, in the cases of *Commissioner vs. Southwestern Consolidated Corporation,* decided April 19, 1941, and *Commissioner vs. Alabama Asphaltic Limestone Company, Inc.,* decided May 5, 1941.

2. The decision of the Circuit Court of Appeals for the Ninth Circuit involves an important question of federal law which, though difficult of application, has been interpreted in a long series of Board of Tax Appeal decisions at variance with the holding of the Ninth Circuit. Prior to *LeTulle vs. Scofield,* 308 U. S. 415, January 2, 1940, the Board in a series of cases involving both the question of the proper basis for depreciation and depletion and the right to deduct losses by bondholders who on insolvency foreclosures received stock for bonds. All of these Board cases had followed the reasoning and decisions of the Kitselman and the Newberry cases.

In re *Leckie*, 37 BTA 252
Howard Hotel Corp., 39 BTA 1147
Sunstein, BTA Memo Docket, No. 82529 (CCH 9954-E, February, 1938)
Altshuler, BTA Memo Docket, No. 84568 (CCH 10432-C, August 27, 1938)
Post Office Building Co., BTA Memo Docket No. 93083 (CCH 10795-B, July 28, 1939)
Southwest Consolidated Corp., BTA Memo Docket No. 93321 (CCH 10808-I, August 25, 1939)
York Furniture Company, BTA Memo Docket No. 92778 (CCH 10825-B, September 18, 1939)

Immediately following the LeTulle decision on February 14, 1940, the Board decided the case of *Alabama Asphaltic Limestone Co., Inc.*, 41 BTA 324. The influence of the LeTulle decision is evidenced in both the majority and dissenting opinions in this Board decision. Thereafter the Board has decided the following cases in accordance with its prior holdings and continues to distinguish the LeTulle decision.

New Haven and Shore Line Railway Company, BTA Memo Docket No. 98309 (CCH 11014-A, February 9, 1940). The basis for depreciation of the prior insolvent corporation was accepted as the basis for the bondholders' new corporation. This case was argued before the Circuit Court of Appeals for the Second Circuit on April 7, 1941. The decision has not been filed at this writing.

New President Corp., BTA Memo Docket No. 96367 (CCH 11111-B, May 18, 1940) and *James Q.*

Newton Trust, 42 BTA 73, August 6, 1940.

On March 12, 1941, the Board also decided *Agnes Neustadt*, 43 BTA Docket No. 99935, and distinguished the LeTulle case from the Kitselman case on the ground that in the LeTulle case there was in reality a sale "lurking in the disguise of reorganizations."

Palm Springs Holding Corp., BTA Memo Docket No. 95262 (CCH 11045, March 23, 1940). This involves the basis of the bondholders' company for depreciation. However a decision for the Commission was filed May 14, 1941. Docket No. 9661 ..... Fed. (2d) ....., reversing the Board.

3. That the decisions of the Ninth Circuit has largely resulted from a misconstruction of the decision of this court in *LeTulle vs. Scofield*, 308 U. S. 415.

4. That it is important that this court should clarify the application, if any, of its decision in the LeTulle case to reorganizations of defaulted bond issues, because courts (other than the Ninth Circuit) and the Board of Tax Appeals since the rendition of the LeTulle decision, have uniformly held the LeTulle decision consistant with reorganizations of defaulted bond issues. In this respect the decision of the Ninth Circuit is in conflict with the Fifth, Sixth and Seventh Circuit Courts of Appeal and the Board in its application of the LeTulle decision. Analyses of the LeTulle decision as applied

to various Board of Tax Appeal cases and the statute have been reviewed by various students who disagree with the conclusions of the Commissioner and the Ninth Circuit. (See C. C. H. *Illustrative Bulletin E*, May 8, 1940, *The Meaning of LeTulle vs. Scofield.* Sil[illegible]erson, 18 Tax Magazine, 492 (1940), *Income Tax Problems of Reorganization,* Virgil S. Chandler, December, 1940, University of Kansas City Law Review, Volume IX, page 22).

5. That the decision of the Circuit Court of the Ninth Circuit is such a departure, as above stated, from the accepted and usual course of decisions in covering the subject matter as to justify this court in exercising its powers.

WHEREFORE, the petitioners respectfully pray that writs of certiorari be issued out of and under the seal of this honorable court directed to the Circuit Court of the Ninth Circuit commanding that court to certify and send to this court on the date designated in said writ full and complete transcript of record of all proceedings in the cases entitled on its docket *Commissioner of Internal Revenue vs. Bondholders Committee, Marlborough Investment Company, First Mortgage Bonds, No.* 9602 and *Commissioner of Internal Revenue vs. Marlborough House, Inc., No.* 9603, to the end that the said cases may be reviewed and determined by this court as provided by law and that your petitioner may have

such other and further relief in the premises as to this honorable court may seem proper.

Dated at Seattle, Washington, May 31, 1941.

BONDHOLDERS COMMITTEE, MARLBOROUGH INVESTMENT COMPANY, FIRST MORTGAGE BONDS

STEPHEN V. CAREY,

WM. Z. KERR,

R. B. ALBERTSON,

KERR, McCORD & CAREY.

Attorneys for Petitioner

MARLBOROUGH HOUSE, INC.

STEPHEN V. CAREY,

WM. Z. KERR,

R. B. ALBERTSON,

KERR, McCORD & CAREY.

Attorneys for Petitioner

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BRIEF IN SUPPORT OF PETITION FOR WRITS OF CERTIORARI

OPINIONS OF THE COURT BELOW

The petition of the taxpayers prevailed before the Board of Tax Appeals. The opinion of the Board of Tax Appeals is entitled In re *Marlborough House, Inc. vs. Commissioner of Internal Revenue*, and *Bondholders Committee, Marlborough Investment Company, First Mortgage Bonds, vs. Commissioner*, 40 BTA 822 (R. 23-43).

The Commissioner prevailed before the Circuit Court of Appeals for the Ninth Circuit. The opinion is reported as *Commissioner of Internal Revenue vs. Bondholders Committee* and *Commissioner of Internal Revenue vs. Marlborough House, Inc.*, 118 Fed. (2d) 511 (R. 261-281).

JURISDICTION

1. The jurisdiction, or jurisdictions, of this court is invoked under Section 240 (a) of the Judicial Code as amended by Act of February 13, 1935, 43 Stat. 938, 28 U. S. C. A. Section 347 (a).

2. The date of the judgment of the Circuit Court of Appeals of the Ninth Circuit herein sought to be reviewed is March 8, 1941, and petition for rehearing was denied April 17, 1941.

3. The cases believed by your petitioner to sustain your jurisdiction and relied on for the exercise thereof are referred to in the proceeding petition, pages 11-14, to which reference is made for the sake of brevity.

STATEMENT OF THE CASE

For the sake of brevity, we refer to the proceeding petition, page 1 to 8.

ASSIGNMENTS OF ERROR

1. The Circuit Court of Appeals for the Ninth Circuit erred in refusing to hold that the steps taken by the Bondholders Committee, the Marlborough Investment Company, and Marlborough House, Inc., constituted a reorganization whereby

the Committee and the Marlborough House, Inc., as parties to the reorganization were entitled to the same basis for depreciation as the predecessor insolvent mortgagor corporation, the Marlborough Investment Company.

2. The Circuit Court of Appeals for the Ninth Circuit erred in refusing to hold that this case was controlled by rules laid down in *Commissioner vs. Newberry L. & C. Co.*, 94 Fed. (2d) 447 (C. C. A. 6th), and *Commissioner vs. Kitselman*, 98 Fed. (2d) 458 (C. C. A. 7th).

3. The Circuit Court of Appeals for the Ninth Circuit erred in interpreting the holdings of the *LeTulle vs. Scofield*, 308 U. S. 415, and *Helvering vs. Tyng*, 308 U. S. 527, as overruling the cases of *Commissioner vs. Kitselman*, supra, and *Commissioner vs. Newberry L. & C. Co.*, supra.

4. The Circuit Court of Appeals erred in holding that there was a lack of continuity of proprietary interest between the Marlborough Investment Company, the Committee, and the Marlborough House, Inc., because the stockholders of the predecessor, the Marlborough Investment Company, did not participate in the stock of the Marlborough House, Inc.

5. The Circuit Court of Appeals erred in failing to hold that Section 113 (a) (7) was applicable to the facts found by the Board, even if Section 113 (a) (6) cited in the Board's opinon was inapplicable.

6. The Circuit Court of Appeals erred, after holding there was a break in the continuinty of proprietary interest, in refusing to consider the cash advanced by the Committee plus the par value and cost of bonds, a total of $466,968, as the basis of the cost of the property under Section 113 (a) of the 1932 Revenue Act, rather than the amount bid at the foreclosure sale, $340,425.

ARGUMENT

1. The Circuit Court of Appeals for the Ninth Circuit erred in refusing to hold that the steps taken by the Bondholders Committee, the Marlborough Investment Company, and Marlborough House, Inc., constituted a reorganization whereby the Committee and the Marlborough House, Inc., as parties to the reorganization were entitled to the same basis for depreciation as the predecessor insolvent mortgagor corporation, the Marlborough Investment Company.

Each taxpayer is entitled to an allowance against gross income for the exhaustion, wear, and tear of property used in the trade or business, including reasonable allowance for obsolescence. This depreciation allowance is provided in Section 23 (k), Act of 1932. (26 U. S. C. A. Rev. Act 1932, p. 491). (See Appendix for statutes).

The basis upon which the depreciation is allowed, Section 23 (m), Act of 1932, (Id. p. 491) is by Section 114 of the Act (Id. p. 519) the same adjusted basis as provided in Section 113 (b) (Id. p. 518)

"for the purpose of determining the gain or loss upon the sale or other disposition of such property."

The adjusted basis for determining gain or loss under subsection (a) of 113 is "the cost of such property" but there are thirteen exceptions to cost as the basis (Section 113 (a) (1) to (13) (Id. p. 514 to 518). Three of these exceptions are pertinent to the present case; Section 113 (a) (6) (Id. p. 515), tax-free exchanges generally; Section 113 (a) (7) (Id. p. 516), transfers to a corporation where control of property remains in the same persons; and Section 113 (a) (8) (Id. p. 516), property acquired by issuance of stock or as paid-in surplus.

By Section 113 (a) (8) (Id. p. 516), the basis of the assets to the Marlborough House, Inc., is cost in the hands of the Bondholders Committee, because this transaction is a transfer to a corporation controlled by the transferor. Section 112 (b) (5) (Id. p. 511). The taxpayer and Commissioner were agreed on this point in the court below.

Under Section 113 (a) (6) (Id. p. 515), the sixth exception, "If property is acquired upon an exchange in Section 112 (b) to (e) (Id. p. 511 to 513) inclusive, the basis is the same as in the case of property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decrease in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in

which the exchange was made." Under this exception the basis of the depositing bondholders for their stock in the new corporation, the Marlborough House, Inc., would be the same as the basis they had for their deposited bonds in exchange for which they received that stock, provided the exchange for stock is a transaction described in Section 112 (b) to (e) (Id. p. 511 to 513).

Section 112 (b) (3) (Id. p. 511) excepts exchanges of stocks for stock on reorganization using the following language:

> "No gain or loss shall be recognized if stock or securities in a corporation, a party to a reorganization, are in pursuance of the plan of reorganization exchanged solely for stock or securities in such corporation, or in another corporation, a party to the reorganization."

Here the bondholders exchanged their bonds (securities) of the Marlborough Investment Company, an insolvent corporation, for stock in the Marlborough House, Inc., (another corporation). The Board determined as a fact, (1), that there was a reorganization, (2), that the corporations were parties to the reorganization, and (3), that there was a plan of reorganization.

Section 113 (a) (7) (Id. p. 516) fixes the adjusted basis for determining gain or loss in cases of "Transfers to corporation where control of property remains in the same persons." The section provides:

"If property was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50% or more remained in the same persons or any of them, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer."

In the present case, the property was acquired after December 31, 1917, by the Marlborough House, Inc., a corporation, in connection with the reorganization of the Marlborough Investment Company. Immediately after the transfer, the interest and control of the property in excess of 50%, to-wit, 97%, remained in the same persons (bondholders) as controlled the old corporation, Marlborough Investment Company, because the Marlborough Investment Company stockholders' equity had completely disappeared upon its insolvency. This paragraph applies because the property acquired by the Marlborough House was wholly in consideration of the issuance of stock of the Marlborough House, Inc., to the bondholders of the old Marlborough Investment Company.

It is notable that both in Section 113 (a) (6) and Section 113 (a) (7) we must find a reorganization.

Congress has defined reorganization in Section 112 (i). (1) (Id. p. 513), which. so far as applicable, reads as follows:

> "As used in this section and Sections 113 and 115—
>
> (1) The term 'reorganization' means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least the majority of the total numbers of shares of all other classes of stock of another corporation or substantially all the properties of another corporation) * * *
>
> (2) The term 'party to a reorganization' includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation."

The taxpayer contends that the property of the Marlborough Investment Company was acquired in connection with a merger or consolidation described in subdivision (A); namely, the acquisition by one corporation, the Marlborough House, Inc., of substantially all of the properties of the old corporation, the Marlborough Investment Company.

Since the Marlborough Investment Company was confessedly insolvent, its stock was valueless, its assets were a trust fund for the benefit of its creditors, the bondholders.

Graham vs. LaCrosse Ry., 102 U. S. 148, at p. 161;
Mellen vs. Moline Iron Works, 131 U. S. 352;
Hollins vs. Brierfield Coal Co., 150 U. S. 371 p. 385;

Blake vs. McClung, 172 U. S. 239;
Northern Pac. Ry. vs. Boyd, 228 U. S. 482;
Thompson vs. Huron Lumber Co., 4 Wash. 600, at p. 603;
Spinning vs. Allen, 10 Wash. 673.

Its bondholders were entitled to have all of its earnings devoted to the payment of its operating expenses and applied upon the interest and principal payments of the bonded debt. Its operating revenue was the source of nourishment for the bonds, and when the source became insufficient to feed the stockholders, the old company, in accordance with the wish of the Bondholders Committee, approved the foreclosure decree on July 1, 1933, and cooperated with the Committee and the record owners of the property in putting in motion a plan for vesting the title and possession of the properties in the Bondholders Committee, all of which, within a reasonable time, transformed the project, so far as the bondholders were concerned, into a new corporation of which the bondholders were now stockholders in exactly the same proportion as they controlled the properties on July 1, 1933. The business of the old corporation through this transition was continued by the new corporation by the equitable owners, the bondholders. In substance what happened was a reorganization of the Marlborough Apartment House properties under circumstances which the Commissioner always heretofore con-

tended was a reorganization, not entitling the bondholders to claim a loss.

The acquisition of assets through the medium of foreclosure proceedings does not of itself take a transaction out of the reorganization provision of the revenue statutes.

DeBlois vs. Commissioner, 36 Fed. (2d) 11 (C. C. A. 1st)
C. H. Mead Coal Co. vs. Commissioner, 72 Fed. (2d) 22 (C. C. A. 4th).
Securities Co. vs. Commissioner, 64 Fed. (2d) 330 (C. C. A. 2nd).
Shoenberg vs. Commissioner 77 Fed. (2d) 446 (C. C. A. 8th).
United States vs. Galveston-Houston Electric Co., 84 Fed. (2d) 516 (C. C. A. 1st) Certiorari denied, 299 U. S. 590.

The formation of a new corporation for the purpose of taking of assets of another corporation in financial difficulty is one of the common types of reorganization recognized by all reorganization statutes, and the component steps of what may be regarded as a single or general plan looking to the reorganization of a corporation will not be treated separately.

Kansas City Ry. Co. vs. Guardian Trust Company, 240 U. S. 166, at pp. 176-177;
Edwards vs. Chile Copper Co., 270 U. S. 452, at p. 455;
Howard vs. Commissioner, 56 Fed. (2nd) 781 (C. C. A. 6th);
Prairie Oil & Gas Co. vs. Motter, 66 Fed. (2nd) 309 (C.C. A. 10th);
West Texas Refining & D. Co. vs. Commissioner, 68 Fed. (2nd) 77 (C. C. A. 10th);
Ahles Realty Corp. vs. Commissioner, 71 Fed.

(2nd) 150 (C. C. A. 2nd), certiorari denied, 293 U. S. 611;

First Seattle D. H. Nat. Bank vs. Commissioner, 77 Fed. (2nd) 45 (C. C. A. 9th);

Starr vs. Commissioner, 82 Fed. (2nd) 964 (C. C. A. 4th).

Sage vs. Commissioner, 83 Fed. (2nd) 221 (C. C. A. 2nd);

Miller vs. Commissioner, 103 Fed. (2nd) 58;

Portland Oil Co. vs. Commissioner, 109 Fed. (2nd) 479;

Diescher vs. Commissioner, 110 Fed. (2nd) 90;

Snowden vs. McCabe, 111 Fed. (2nd) 743;

Morgan vs. Helvering, 117 Fed. (2nd) 334, at p. 336;

Fletcher Cyc. Corp., Vol. 15, Sec. 7226;

19 *Corpus Juris Secundum, Corporations*, Secs. 1578, 1585.

In 1924, after the 1924 Revenue Act embodied Section 203 and Section 204 in substantially the form, as Sections 112 and 113, of the 1932 Act, general counsel for the Internal Revenue Department issued *Bulletin IT* 2071 (C. B. III-2, p. 34) for guidance of the Department and taxpayers on this subject. The bulletin denies taxpayers the right to take losses on bonds in such reorganizations. In part it says:

> "The most common form of reorganization, especially in the case of defaulting corporations, is a reorganization in connection with an execution or foreclosure sale. It is often advisable for the bondholders of such a corporation to formulate some scheme of reorganization and in order to consummate the reorganization they may enter into an agreement for this purpose, appoint a committee or other agent to

represent them, to purchase the property at a foreclosure sale for their benefit, to form a new corporation and to transfer the property to it in return for stock or bonds or both. In the case of foreclosure, the reorganization takes place by procuring a sale under the mortgage, purchasing the property at the sale, and causing the same to be transferred to another corporation organized for that purpose by the bondholders. When the reorganization is through a foreclosure sale, stockholders need not be joined in the plan nor given the right to participate, and if they are given the right to participate it is purely a matter of favor."

Following this memorandum, the Commissioner consistently refused to allow losses to bondholders where they acquired the mortgaged property through foreclosure proceedings and became stockholders of the identical property instead of bondholders.

When the matter came before the Board in *Commissioner vs. Kitselman*, 33 BTA 498, the Board held that there was not a reorganization as defined in Section 112 (i) of the 1928 Act. The Commissioner secured a reversal of this holding before the Circuit Court of Appeals of the Seventh Circuit, *Commissioner vs. Kitselman*, 89 Fed. (2nd) 458. In securing this reversal, the Commissioner in the Kitselman case presented many of the foregoing authorities and the argument we here use is almost identical with the argument used by the Commissioner to this point in the Kitselman case.

The Circuit Court of Appeals of the Seventh Circuit accepted the government's position as sound and said in part:

> "Although the instant situation is rather novel in the aspect that neither the stockholders nor corporation participated in any way in the plan whereby the mortgage was foreclosed, the new company formed, and the assets transferred to the committee and by it to the new company, we believe a statutory reorganization was effected. The only reason the stockholders did not participate in the plan was that their stock represented no assets and was valueless, and therefore they were without right to speak. In re 620 Church Street Corporation, 299 U. S. 24, 27.
>
> "Bondholders are ordinarily viewed merely as creditors, but when the assets of the corporation are less than its obligations, the bondholders are in actuality and for all practical purposes pretty much the corporation. All that remains for the stockholders is the corporate charter—the corpse of the defunct corporation. When the new corporation was formed by the bondholders' representatives, it received all the corporate assets in exchange for the new company's stocks and bonds. The old stockholders as such received nothing.
>
> "There may not have been a reorganization in the sense that the capital structure was changed (except as to the bonds), but the essense of the corporate life—all its assets—were transferred by its bondholders to a new corporation in exchange for that corporation's stocks and bonds. It is not indispensable to a reorganization that there be a dissolution of the old corporation.
>
> "The novelty of this situation arises from the lack of participation by stockholders of the tranferor corporation. If they participated,

there would be little doubt as to the existence of a reorganization.

"It is clear that the bondholders were the moving spirit and were treated as the owners in fact, and it follows that they must be viewed as a class of 'stockholders' somewhat akin to preferred stockholders with cumulative dividend rights. Their position was stepped up by reason of what had occurred and the finding that there was no equity over the lien of the mortgage. Where the assets of the corporation fall far below the amount required to pay the bondholders in full, the bondholders in bankruptcy reorganization supersede the stockholders. They acquire the stockholders' rights to manage the corporate affairs. There is a difference between the position of stockholders in a case like the present one and stockholders of a corporation in bankruptcy proceeding under section 77B (11 U. S. C. A. §207) to a reorganization, but the analogies are sufficient to justify a study of the decisions in the latter field.

"We conclude that there was a reorganization within the contemplation of the statute and that therefore there was no loss realized upon the exchange of the bonds for the stock and bonds of the new company."

Kitselman petitioned for a writ of certiorari to this court which was denied, 302 U. S. 709. The Commissioner's brief reiterated the position the Commissioner had successfully urged before the Circuit Court. For instance, at page 11 of the government's brief in certiorari, we find the following statement:

"We submit that where the corporation's liabilities greatly exceeded its assets, so that only bondholders participated in the reorganization, it is sufficient that the bondholders received a substantial interest in the new corporation in

the form of common stocks and bonds. The only reason the stockholders did not participate in the plan was that their stock represented no assets and was valueless, and therefore they were without right to speak. See in re 620 Church St. Corp., 299 U. S. 24, 27. While bondholders are ordinarily viewed merely as creditors, when the assets of the corporation in receivership are less than its obligations the bondholders are for all practical pruposes the corporation. All that remains for the stockholders is the corporate charter. Here it is clear that the bondholders were the moving spirit in the reorganization and acted throughout as the owners in fact of the corporation's assets. The decision of the court below gives practical and common sense recognition to a well defined type of business reorganization."

In the meantime, while the law was developing to the Kitselman case, the Board had taken the position that the basis for depreciation of property in the hands of foreclosing bondholders and corporations organized by them for the purpose of acquiring the property foreclosed was either the fair market value of the property at the time it was sold on foreclosure or the fair market value of bonds used by the bondholders in payment of the price bid at the foreclosure sale. *Suncrest Lumber Company*, 25 BTA 375, *Newberry Lumber & Chemical Co.*, 33 BTA 150. The taxpayer in the Newberry case sought a review by the Circuit Court of Appeals of the Sixth Circuit.

In the Newberry case the corporation organized by the bondholders, and to which they transferred

the property after a foreclosure sale, had placed on its books for the major portion of the property a value which represented the cost at which they were carried on the books of the predecessor corporation less depreciation. The court in part said:

> "In the case at bar neither the petitioner nor its stockholders received any profit from the reorganization. The predecessor corporation transferred all of its assets to the petitioner, and immediately after, the transferor, through its bondholders, was in control of the assets transferred. It makes no difference that the transaction was effected by the bondholders' committee, for that committee acted for and represented the bondholders in the old corporation, who became bondholders and stockholders in the reorganized corporation. Nor is it important that the committee represented no stockholders in the original corporation, since it did represent the bonds, which are securities as indicated in the Minnesota Tea Company and Watt Cases, supra. In our opinion there was a reorganization with in the meaning of the statute. Where there is a reorganization there is no taxable gain in the transaction. In such case, too, the statute provides that the capital base for the reorganized corporation is the cost of the assets to the old corporation. Section 113 (a) (7) and section 114 (a) and (b) (1), of the Revenue Act of 1928, 26 U. S. A. **113, 114 notes. It was accordingly error for the Board to establish the capital base on cost price paid at the decretal sale. All the assets, including the inventories and accounts receivable, were owned by the old corporation and were transferred to the new. It is not our province on this review to determine what their

cost to the old corporation was in order to establish a base value for gain or loss on the inventory or for depletion and depreciation on the assets for the seven months here in question and for the future. Those are matters for administrative determination and must be made by the Board of Tax Appeals. To permit them to be made, the order of the Board is set aside and the cause remanded to it for a new hearing."

We believe it can be safely asserted that after the Kitselman and the Newberry decisions the problem was considered answered so long as congress did not substantially change the applicable sections of the Revenue Acts, and the Board of Tax Appeals thereafter decided their cases on the basis of these decisions.

When congress was considering the Revenue Act of 1934, there were suggestions that the exchange and reorganization portions of the statute should be repealed or drastically altered. The report of the Ways and Means Committee, found in C. B. 1939-1, part 2, pp. 564-565, is very illuminating. At page 564 the Committee reported:

"* * * Furthermore, the retention of the other reorganization provisions will prevent large losses from being established by bondholders and stockholders who receive securities in a newly reorganized enterprise which are substantially the same as their original investments * * * Likewise, many corporations have defaulted upon the dividends on their cumulative preferred stock, or upon the interest on their bonds. These corporations, in order to obtain necessary credit from the banks, are ar-

> ranging with their preferred stockholders to accept new common stock and with their bondholders to accept noncumulative preferred stock in place of preferred stock or bonds now held. If the reorganization provisions were omitted from the bill, these stockholders and bondholders could take large losses, although they still retain an interest in the corporation. Although the losses in the cases given would be subject to the new limitations the committee has placed upon the deduction of capital losses, the net result, during the next year or more, of omitting the reorganization provisions might be a loss of taxes to the Treasury."

The report of the Senate Finance Committee (CCB 1939-1, part 2, pp. 598, 599) came to the same conclusion, and the Acting Secretary of the Treasury (Report of subcommittee of Ways and Means Committee, 73rd Congress, 2nd Sess., p. 9) said:

> "In the second place, reorganizations today are generally being carried out in order to revise the capital structures of unsuccessful or insolvent enterprises. The immediate result of abolishing the reorganization provisions would be to permit the thousands of bondholders and stockholders of such organizations to establish losses, even though they obtain and retain securities in a new enterprise which is substantially the same as their original investment. Even though it be required that such losses can only be deducted from capital gains, a wide door will be opened to reduction of tax liability."

There has been no substantial change in these provisions of the statute by any succeeding congress and we, therefore, submit that every intendant should be indulged by the court to sustain the

practice that has grown up and been encouraged by the Treasury Department.

Other provisions of the Internal Revenue Acts permit bonds to be replaced by stock in such cases without stamp tax on the transfer. (See Schedule A-9 of Title VIII of the Revenue Act of 1926, as amended by section 724 of the Revenue Act of 1932.)

The first substantial encouragement to the Commissioner in his change of position came with the decision of *LeTulle vs. Schofield*, 308 U. S. 415, and its companion case *Helvering vs. Tyng*, 308 U. S. 527.

2. The Circuit Court of Appeals of the Ninth Circuit erred in refusing to hold that this case was controlled by rules laid down in *Commissioner vs. Newberry L. & C. Co.*, 94 Fed. (2d) 447, and *Commissioner vs. Kitselman*, 98 Fed. (2d) 458.

Judges Wilbur and Healy, while recognizing that the Kitselman and Newberry cases were factually distinguishable from the LeTulle case, plainly held that these cases were overruled by the following excerpt from the LeTulle decision:

> "When the consideration is wholly the transferee's bonds, or part cash and part such bonds, we think it cannot be said that the transferor retains any pecuniary interest in the enterprise. On the contrary, he becomes a creditor of the transferee; and we do not think that the fact referred to by the Circuit Court of Appeals, that the bonds were secured solely by the assets transferred and that, upon default, the bondholders would retake only the property

> sold, changes his status from that of a creditor to one having a proprietary stake, within the purview of the statute."

Judge Mathews, in his concurring opinion, held with the Commissioner on an independent analysis of the statutes and concluded by distinguishing the problems of the Kitselman and the Newberry cases from this case and the LeTulle and Tyng cases. It is unnecessary to debate the validity of this distinction, for Judge Mathews, since the Marlborough decision, appears to agree with the Commissioner that they have been overruled. In the case of *Commissioner vs. Palm Springs Holding Corporation*, decided May 14, 1941, Judge Mathews uses the following language:

> "The contrary view derives no support in *Commissioner vs. Kitselman* (7th Circuit, 89 Fed. (2nd) 458), or from *Commissioner vs. Newberry Lumber & Chemical Co.*, (C. C. A. 6th) (94 Fed. (2nd) 447), for the Kitselman and Newberry cases, so far as revelent here, were in effect overruled by *LeTulle vs. Schofield and Helvering vs. Tyng*, supra."

Judge Mathews' idea of distinguishing the Kitselman and Newberry cases was not suggested by the Commissioner's attorneys. On the contrary the government's attorneys in the present case, both in brief and oral argument before the Ninth Circuit, frankly admitted that the Kitselman and Newberry cases supported the taxpayer's position and contended that these cases were specifically overruled by the LeTulle decision.

Applying the LeTulle decision, the majority of

the Ninth Circuit suggested as reasons to support the Marlborough decision that there was a lack of continuity of proprietary interest that your decisions require, and that a reorganization in the bankruptcy sense may be something from a revenue act reorganization.

The cases and texts we have heretofore cited, and the decision of the Fifth Circuit on May 5, 1941, in the *Alabama Asphaltic Limestone* case, Docket No. 9569, — Fed. (2nd) — (hereafter considered), set forth arguments which we submit should satisfy you that there is no lack of continuity of proprietary interest in the present case.

Judge Wilbur was unwilling to apply the analogy under a reorganization under Section 77 (b) of the Bankruptcy Act (In re 630 *Church St. Corporation*, 299 U. S. 24) to the reorganizations within the exceptions of Section 112 and Section 113 of the Revenue Act of 1932.

When the stockholders' equitable interest has disappeared owing to insolvency of the corporation, the Bankruptcy Law admittedly permits a reorganization in which creditors only are permitted to participate (*Case vs. Los Angeles Lumber Company*, 308 U. S. 106). True, such bankruptcy reorganizations may be as Judge Wilbur says, "advan geous to the creditors and therefore within the po..cy of the Bankruptcy Act," but is it not equally true that a reorganization under Section 112 of the Revenue

Act may still be "advantageous to the creditors" and therefore within the policy of the Revenue Act?

Section 111 of the 1932 Act, computation of gain or loss, reads as follows:

> "(a) Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount *realized* therefrom over the adjusted basis provided in section 113 (b), and the loss shall be the excess of such basis over the amount *realized*.
>
> "(b) Amount Realized. The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received." (Id, page 510)

Realization of gains and losses on sales and other dispositions of property are the subjects dealt with in Subtitle B, Part II of the Revenue Act of 1932.

Under the present circumstances there has been no realization of profit or loss in the disposition of the property. The stock equity has disappeared with insolvency prior to disposition. The same properties are still operated for the benefit of the same substantial owners. There seems no substantial reason why a reorganization for the benefit of stockholders should be within the Revenue Act but a reorganization for the benefit of bondholders excluded from the Revenue Act. If such a distinction is valid, a premium is given to the worthless stock interest because it can say to the secured

creditor, who has become the substantial owner, "Give us a participation in the reorganized company thereby gaining our base for depreciation and on future sales, otherwise you must accept the present depressed value."

This is out of harmony with your bankruptcy holdings and is unsound in policy and, we submit, illustrates the fallacies of Judge Wilbur's distinction.

3. The Circuit Court of Appeals for the Ninth Circuit erred in interpreting the holdings of the *LeTulle vs. Scofield*, supra, and *Helvering vs. Tyng*, supra, as overruling the cases of *Commissioner vs. Kitselman*, supra, and *Commissioner vs. Newberry L. & C. Co.*, supra.

As was aptly said by the Board of Tax Appeals in the case of *Agnes Neustadt*, 43 BTA ——, Docket No. 99935, March 15, 1941, LeTulle and Tyng cases really involved transactions where sales were "lurking in the disguise of reorganizations."

Both the difficulty of analyzing and applying the principle of continuity of proprietary interest and the proper interpretation of the LeTulle case is probably best illustrated in the decision of the Board of Tax Appeals rendered February 14, 1940, in *Alabama Asphaltic Limestone Company case*, 41 B.T.A. 324. The majority of the Board followed the Kitselman and Newberry cases and distinguished

the LeTulle decision. Two members of the Board dissented without opinion. Two members concurred in a dissenting opinion by Murdock. Disney filed an additional dissenting opinion, as did Melott. It is significant, however, that the Board since that date has consistently held to the rule of the Kitselman and the Newberry cases.

The Circuit Court of Appeals of the Fifth Circuit on May 5, 1941, affirmed the Board in the *Alabama Asphaltic Limestone Company case,* Docket No. 9569, —— Fed. (2nd) ——. This case deals with the identical problem of the Marlborough, namely, the depreciation basis. The creditors, though without liens, were stepped up by insolvency into a proprietary position. The opinion is as follows:

"(*Reorganization v. Sale*)

This was a typical reorganization through a court sale of an insolvent corporation. We think it was a reorganization rather than a gain-and-loss-realizing-sale under the income tax laws. The definitions of reorganizations in Revenue Act of 1928, Sec. 112 (i), contemplate that there be transfers of title by sale. No difference is indicated between a private and a court sale. What is important is the purpose or plan, and the result of the sale, as defined by the statute. We follow the Board in applying the words of Sec. 112 (i) (1): 'The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of * * * substantially all the properties of another corporation).' As settled in *LeTulle vs. Scofield,* 308 U. S. 415 (40-1 USTC, §9150), and cases cited on page 420, acquisition by simple sale for cash, or cash and notes

or bonds, is not meant, but on acquisition which has the character of a merger, a transfer bodily of the properties of one corporation to another, accompanied by a retention of a 'substantial stake,' a 'proprietary interest,' in the acquiring corporation by those interested previously in the properties. The LeTulle case and *Helvering vs. Tyng*, 308 U. S. 527 (40-1 USTC, §9152), settled that such 'proprietary interest' is not retained by the transferror becoming a creditor of the acquiring corporation. They are not like the present case, for the whole capital stock here was taken by the transferror. The question here, not present in those cases, is What sort of relationship to the transferring corporation must those have who ultimately receive the stock which is paid to the transferring corporation? Must they be stockholders in the latter?"

(*Relationship of Noteholders to Transferring Corporation*)

In the case of a merger, the transferring corporation ceases to do business. What is paid for its properties goes to discharge its debts first, and the remainder to its stockholders, if solvent. When it is confessedly insolvent, or is so adjudged as in this case, the stock is valueless, the assets have become a trust fund for the benefit of the creditors. The officers are trustees and the creditors the beneficiaries. So in bankruptcy, the creditors alone make determinations and control the disposition of the property. The corporation is not dead, it still has title to its properties, but the creditors rather than the stockholders are the beneficial owners. We are of opinion that an insolvent corporation can be merged or reorganized by a transfer of its properties in accordance with the wishes of its creditors, either by act of the corporation or by a judicial sale by a court acting for that purpose. The consideration, since the business of the old corporation is at an end,

will be distributed to its creditors rather than its stockholders, because the proprietary interest in the properties is, since the insolvency, in them. What distinguishes the transaction as a merger rather than a sale is that what is paid for the properties is not money or a money measured obligation, but in whole or substantial part stock in the acquiring corporation, so that the former proprietors of the property continue to have a proprietary interest in it. In this case, but for the two dissenters, there would have been no sale at all, the noteholders would have taken stock in the old instead of the new corporation, the former capital stock being ignored or subordinated because of the financial condition of the company. What has happened was not intended by the parties or the court as a sale, but a reorganization by merger. Tax consequences on that basis are in accordance with the truth and justice of the case. *Commissioner vs. Southwest Consolidated Corporation,* —— Fed. (2) ——; *Commissioner vs. Kitselman,* 89 Fed. (2) 458 (37-1 USTC, §9237); *Commissioner vs. Newberry L. & C. Co.,* 94 Fed. (2) 447 (38-1 USTC, §9110). The noteholders were in fact informal stockholders in the transferring corporation, according to *Arnold vs. Phillips,* —— Fed. (2) ——."

The Fifth Circuit had already arrived at practically the same conclusion in *Commissioner vs. Southwestern Consolidated Corporation,* —— Fed. (2nd) ——, decided April 19, 1941.

For these reasons it would seem that the LeTulle and Tyng cases have been misinterpreted by the Ninth Circuit.

4. The Circuit Court of Appeals erred in holding that there was a lack of continuity of proprietary inter-

est between the Marlborough Investment Company, the Committee, and the Marlborough House, Inc., because the stockholders of the predecessor, the Marlborough Investment Company, did not participate in the stock of the Marlborough House, Inc.

Commissioner vs. Newberry L. & C. Co., 94 Fed. (2nd) 447 (C. C. A. 6th);
Commissioner vs. Kitselman, 98 Fed. (2nd) 458 (C. C. A. 7th);
Alabama Asphaltic Limestone Company vs. Commissioner, Docket No. 9569, — Fed. —.

5. The Circuit Court of Appeals erred in failing to hold that Section 113 (a) (7) was applicable to the facts found by the Board, even if Section 113 (a) (6) cited in the Board's opinion was inapplicable.

Judge Mathews in his concurring opinion in the present case attempted to analyze the applicable Revenue Statutes and said in part:

> "The Board did not hold, nor do the taxpayers contend, that either of the exchanges here involved was an exchange described in §112 (b) (1), 112 (b) (2), 112 (b) (4), 112 (b) (5), 112 (c), 112 (d) or 112 (e). The implied holding (12) that they were exchanges described in §112 (b) (3) was, as I have shown, inconsistent with the findings and contrary to the evidence. There was, therefore, no basis for holding that these cases or either of them came within the exception specified in §113 (a) (6). The Board *did not hold, nor do the taxpayers contend, that either of the cases came within any of the other exceptions specified in* §113 (a)." (Italics supplied)

We respectfully submit that the learned justice was in error in the italicized statement. Both the Board and the taxpayers were relying upon, cited and argued Newberry Lumber & Chemical Co. case as controlling the issues, and the Newberry Lumber Company case specifically turns on subdivision 113 (a) (7). In addition the taxpayer was relying upon, cited and argued other decisions of the Board of Tax Appeals including *Alabama Asphaltic Limestone Company vs. Commissioner*, 41 B. T. A. 324, which specifically turn upon Section 113 (a) (7).

It is not our understanding of the law that the Board's decision should be reversed because the Board has neglected to cite all of the sections of the Revenue Act that might be applicable. When the Board's opinion clearly showed reliance upon the Newberry Lumber & Chemical Company case, we submit it would be unreasonable to assert that the applicable section of the statute had not been relied on because other sections of the statute also had been cited.

But if there is any merit in Justice Mathews' position, yet Section 113 (a) (7) entitled the taxpayer to the basis he has claimed, the Board should not have been reversed merely because it had failed to specifically say it was applying Section 113 (a) (7). The findings of the Board should have been taken and the law applied even if the reasoning of the Board was erroneous. *Helvring vs. Gowran*, 302

U. S. 238, *Hormel vs. Helvering*, —— U. S. ——, decided March 17, 1941.

In any event the petition for rehearing specifically invited the judges of the Ninth Circuit to consider the application of Section 113 (a) (7) to the facts as found by the Board, which they failed to do.

6. The Circuit Court of Appeals erred, after holding there was a break in the continuity of proprietary interest, in refusing to consider the cash advanced by the Committee plus the par value and cost of bonds, a total of $466,968, as the basis of the cost of the property under Section 113 (a) of the 1932 Revenue Act, rather than the amount bid at the foreclosure sale, $340,425.

In view of the conclusion reached by the Ninth Circuit that there had been a break in the continuity of proprietary interest, which prevented the taxpayer from having the benefit of the basis of the Marlborough Investment Company for depreciation, it seems inevitable that the taxpayer was entitled to a determination of the taxable effect of such a break in continuity.

Section 113, (a) of the Act of 1932 makes the basis of property its cost with exceptions which the Ninth Circuit holds are inapplicable. What does the record show as the cost to the Bondholders Committee?

The Marlborough Investment Company was insolvent and foreclosure proceedings were pending. On July 1, 1933, the Bondholders Committee re-

ceived possession, conveyances from the record owners of the mortgaged property and the insolvent Marlborough Investment Company approved the entry of a decree of foreclosure on that date. The Committee was trustee for all the bondholders who deposited their bonds. To secure the possession and conveyance, on July 1, 1933, the Committee paid $10,025. Through the Committee's agent, the property was managed from July 1 to November 20, 1933, and in the meantime a foreclosure sale was conducted at which the Bondholders Committee purchased the property for a deposit of bonds of a face value of $441,100, together with $6,425.64 cash to cover expenses of the proceedings and an additional sum of $9,418.24 cash to pay off non-depositing bondholders.

Because of the broad powers given the Bondholders Committee by the deposit agreement, the Commissioner claimed the right to tax the Committee as an association with corporate powers. In this the Commissioner was sustained by the Board of Tax Appeals, 40 B. T. A. 882. The Committee did not attempt to appeal this ruling of the Circuit Court.

Section 1111, subdivision (a) (2) of the Act of 1932 defines "corporations" as follows:

> "(a) When used in this Act—* * * (2) the term 'corporation' includes associations, joint-stock companies, and insurance companies."

It follows that the term "corporation" as used in Section 113 (a) (8) and Section 114 (b) (5) must apply to the transfer of the physical assets to the Bondholders Committee entitling the Bondholders Committee to retain their original investment cost in the bonds for their basis of gain and loss. The Committee took the same basis for depreciation and gain and loss on future disposition as held by the individual bondholders. *Morrissey vs Commissioner,* 296 U. S. 344. The Committee, therefore, is in the position as if it had invested in cash and in bonds it held in trust for the bondholders a total of $466,968.

The Commissioner only allowed the price bid at the September 20, 1933, foreclosure sale, $340,425, instead of the cost to the bondholders and Committee of $466,968.

The bondholders did not sell or dispose of their bonds by depositing them with the Committee, nor did the Committee sell or dispose of the bonds in the foreclosure sale. The bonds were merely deposited with the sheriff in part payment of the purchase price. They were endorsed with a pro rata portion as a payment. The property, none the less, had cost the bondholders the full face value of the bonds. The Marlborough Investment Company being insolvent and all of its assets having been delivered over to the Committee prior to the sale, the true

cost to the Committee was $466,968, since a deficiency judgment against the insolvent corporation was obviously worthless.

The taxpayer and the Commissioner are in agreement that the basis of assets to Marlborough House, Inc., is the cost to the Committee since the assets were transferred to the Marlborough House, Inc., pursuant to Section 112 (b) (5) and Section 113 (b) (8) of the Act of 1932. Under the same logic, the basis of the assets to the Committee should be cost to the depositing bondholders since the Committee has been held to be an association and must be treated as a corporation and the bondholders are the only interested stockholders of the Committee.

CONCLUSIONS

FIRST, this case is particularly appropriate for review because the transactions involve a reorganization within the appropriate sections of the Revenue Act of 1932, contrary to the holding of the Circuit Court of Appeals in the Ninth Circuit;

SECOND, the Circuit Court's decision is in conflict with the Newberry and the Kitselman cases with many Board decisions both before and since this case was decided by the Circuit Court;

THIRD, the decision of the Ninth Circuit misapplies and misconstrues the holding in *LeTulle vs. Scofield* and *Commissioner vs. Tyng;*

FOURTH, the holding of the Ninth Circuit is in conflict with more recent cases of *Commissioner vs. Alabama Asphaltic Limestone Co.* and *Commissioner vs. Southwest Consolidated Corporation*, of the Fifth Circuit;

FIFTH, the question of law involved is in confusion and should be clarified and is of wide importance in the administration of the Revenue Laws of the United States;

SIXTH, the decision of the Ninth Circuit is a departure from the accepted and usual decisions on the subject made and should be corrected.

Respectfully submitted,

STEPHEN V. CAREY,
WM. Z. KERR,
R. B. ALBERTSON,
KERR, McCORD & CAREY.
Attorneys for Respondents.

APPENDIX

Sections of the 1932 Revenue Act, 26 U. S. C. A., Internal Revenue Acts:

§ 23 Deductions from Gross Income

In computing net income there shall be allowed as deductions:

(k) Depreciation. A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * * (p. 491)

(m) Basis for Depreciation and Depletion. The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be provided in section 114. (p. 491)

§ 114 Basis for Depreciation and Depletion

(a) Basis for Depreciation. The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property. (p. 519)

§ 113 Adjusted Basis for Determining Gain or Loss

(b) Adjusted Basis. The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided. (p. 518)

§ 113 Adjusted Basis for Determining Gain or Loss

(a) Basis (Unadjusted) of Property. The basis of property shall be the cost of such property; except that—

(6) Tax-free exchanges generally. If the property was acquired upon an exchange described in section 112 (b) to (e), inclusive, the basis shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was

made. If the property so acquired consisted in part of the type of property permitted by section 112 (b) to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it. (p. 515)

(7) Transfers to corporation where control of property remains in same persons. If the property was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer. (p. 516)

(8) Property acquired by issuance of stock or as paid-in surplus. If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112 (b) (5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or * * * (p. 516)

§ 112 Recognition of Gain or Loss

(a) General Rule. Upon the sale or exchange of

roperty the entire amount of the gain or loss, de-
ermined under section 111, shall be recognized,
xcept as hereinafter provided in this section.

b) Exchanges Solely in Kind—

* * (3) Stock for stock on reorganization. No
ain or loss shall be recognized if stock or securities
n a corporation a party to a reorganization are, in
ursuance of the plan of reorganization, exchanged
olely for stock or securities in such corporation or
n another corporation a party to the reorganiz-
tion.

4) Same—Gain of corporation. No gain or loss
hall be recognized if a corporation a party to a
eorganization exchanges property, in pursuance
f the plan of reorganization, solely for stock or
ecurities in another corporation a party to the
eorganization.

5) Transfer to corporation controlled by trans-
eror. No gain or loss shall be recognized if prop-
rty is transferred to a corporation by one or more
ersons solely in exchange for stock or securities
n such corporation, and immediately after the ex-
hange such person or persons are in control of the
orporation; but in the case of an exchange by two
r more persons this paragraph shall apply only if
he amount of the stock and securities received by
ach is substantially in proportion to his interest in
he property prior to the exchange. (p. 511)

(i) Definition of Reorganization. As used in this
ection and sections 113 and 115—

(1) The term "reorganization" means (A) a mer-
er or consolidation (including the acquisition by
ne corporation of at least a majority of the voting
tock and at least a majority of the total number of
hares of all other classes of stock of another cor-
oration, or substantially all the properties of an-
ther corporation), or (B) a transfer by a corpora-
ion of all or a part of its assets to another corpora-
ion if immediately after the transfer the transferor
r its stockholders or both are in control of the
orporation to which the assets are transferred, or

(C) a recapitalization, or (D) a mere change in identity, form, or place or organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation. (p. 513, 514)

§ 111 Determination of Amount of Gain or Loss

(a) Computation of Gain or Loss. Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b), and the loss shall be the excess of such basis over the amount realized.

(b) Amount Realized. The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. (p. 510)